(3)

Supreme Court, U.S.
FILED
JAN 5 1993
OFFICE OF THE CLERK

No. 92-913

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

BANCO ESPANOL DE CREDITO, BANESTO BANKING CORPORATION, BANCO TOTTA & ACORES, GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN AG, HARMONY GOLD LTD. HONG KONG, INTERNATIONAL COMMERCIAL BANK OF CHINA, MONROE BANK & TRUST, PHELPS DODGE CORPORATION, and STATE STREET BANK & TRUST COMPANY, as Master Trustee for the Retirement Plans of Atlantic Richfield Company and certain of its subsidiaries,

Petitioners,

—against—

SECURITY PACIFIC NATIONAL BANK and
SECURITY PACIFIC MERCHANT BANK,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

Of Counsel:

EDWARD L. POWERS
RICHARDS & O'NEIL
885 Third Avenue
New York, New York 10022
(212) 207-1200

JACK P. LEVIN
Counsel of Record
LAWRENCE A. DARBY, III
GERARD E. LYNCH
J. JAY LOBELL
HOWARD, DARBY & LEVIN
1330 Avenue of the Americas
New York, New York 10019
(212) 841-1000

Attorneys for Petitioners

10 PP

TABLE OF AUTHORITIES

Cases PAGE

American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981) 4

Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) 3

Reves v. Ernst & Young, 494 U.S. 56 (1990) ..... *passim*

Securities Indus. Assoc. v. Board of Governors, 468 U.S. 137 (1984) 6

Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981) 4

Statutes

15 U.S.C. § 77c(a)(3) 5

15 U.S.C. § 77d(2) 5

15 U.S.C. § 77*l* 6

Other Authorities

Letter of William B. Glidden, Assistant Director, OCC Legal Advisory Services Division, December 18, 1985 7

OCC Circular 181 7

Supreme Court Rule 10.1 4

REPLY BRIEF FOR PETITIONERS

Our petition for certiorari argued that the Court should hear this case because it is both economically and conceptually significant. We emphasized

> – first, that this case determines the legal status of a novel commercial paper-like debt instrument that constitutes a market exceeding $100 billion annually; and
>
> – second, that—as both then-Chief Judge Oakes and the Securities and Exchange Commission have protested—the majority below fundamentally distorted this Court's test for securities laws coverage by divorcing each element of the test from its essential purpose of distinguishing investors from commercial lenders.

Security Pacific's opposition brief tries to evade these arguments by distorting what this case is about, and fails entirely to rebut the reasons this case requires this Court's attention.

1. Security Pacific's main strategy in opposing the writ is to brush this case aside as just another case about whether loan participations are securities. It is not. Rather, it is about whether loan notes, marketed and sold as investments, are, in economic reality, securities.

The Commission and Judge Oakes demonstrated persuasively that loan notes are not loan participations. Indeed, even the panel majority below did not simply equate loan notes with loan participations; instead, it recognized that loan notes are novel debt instruments that must be analyzed independently under the four-part test set forth in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

Loan note transactions differ dramatically from loan participations. Loan participations are negotiated "among commercial lenders, who [are] motivated by the commercial purpose of operating a lending business." SEC Brief at 2-3. Banks invariably take loan participations as an adjunct to direct lending operations, and often to foster an independent lending relationship with the borrower. *Id.* at 3, 4.

By contrast, commercial lending is the furthest thing from loan note purchasers' minds. As Security Pacific concedes, most loan note purchasers are not even financial institutions. Br. in Opp. at 4. Further, even those financial institutions that purchase loan notes do so *not* through their lending departments but through their separate investing and trading divisions. (11a).

Security Pacific understands fully the investment motivations of loan note purchasers; that is why it markets loan notes as an alternative to commercial paper, and promotes them exclusively on the basis of a higher return than could be realized on alternative investments. (11a-14a). Having geared its entire program to enticing investors, Security Pacific cannot in its brief transform these investors into commercial lenders—and feign that the writ is unnecessary—by restyling loan notes as loan participations.[1]

---

1 Despite its assertion that loan notes are loan participations, Security Pacific concedes in its brief that:

- o loan notes are recently-developed "shorter-term" debt instruments (Br. in Opp. at 2);
- o loan notes are promoted to institutional investors as "investments" competitive with commercial paper (*id.* at 10, 16);
- o Security Pacific transfers "promptly" to investors the entire credit risk on advances to issuers (*id.* at 3,9) (for this reason, while nearly $100 million of Integrated loan notes were outstanding when Integrated defaulted, Security Pacific's total exposure on the Integrated loan note program at the time of default was merely $79,000 (A 750-51));
- o loan notes are sold primarily to non-lending institutions (Br. in Opp. at 4);
- o loan notes are sold for issuers who are not even existing customers of Security Pacific (*id.* at 3);
- o loan notes are sold by non-credit personnel ("other bank employees") from a "room that also housed the operations of [Security Pacific's] transactions of government instruments, foreign-currencies and Eurodollar futures" (*id.* at 4, 16 n.20);
- o Security Pacific limits only its own credit exposure on issuers but places no limit on the amount of loan notes that it sells to investors (*id.* at 3); and

(*footnote continued on next page*)

Indeed, fundamental differences between loan participations and loan note transactions demonstrate why the securities laws *should* apply to loan notes. Unlike loan note transactions, loan participations are individualized transactions in which "participants generally engage in one-to-one negotiation with the lead lender, and at times with the borrower, and can inspect all information [about the borrower], public and non-public, that is relevant, and consequently are able to do their own credit analysis." (Dissent below at 12a). Participants also are able to "obtain other protections, whether in the form of collateral or covenants in the loan agreement." SEC Brief at 23-24. As the Commission explained, it is precisely the ability of commercial lenders

> to verify representations and take supervisory and corrective actions [that] places them in a significantly different posture than the investors sought to be protected through the securities acts . . . . Rather than relying solely on semi-anonymous and secondhand market information, as do most investors, the commercial bank deals "face-to-face" with the promisor.

Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1261-62 (9th Cir. 1976) (Wright, J., concurring) (quoted in the SEC Brief at 24).

Loan note purchasers, by contrast, enjoy no such protections. Security Pacific does not provide purchasers with non-public information it knows regarding issuers. (12a). And because the MPA stipulates that purchasers may participate only on a "silent basis", they are precluded contractually from seeking credit information from the issuer or negotiating lender's pro-

---

- loan notes are sold during telephone conversations in which Security Pacific and purchasers agree in only "minutes" which of the hundreds of issuers' loan notes would be sold, in what principal amount, and at what interest rate and maturity date (*id.* at 5).

Thus, the facts conceded in Security Pacific's brief alone belie its argument that loan notes are really loan participations.

tections.[2] For all of these reasons, the various loan participation cases relied on repeatedly by Security Pacific (Br. in Opp. at 3, 8, 16) are inapposite.[3]

2. The balance of Security Pacific's brief offers only argument regarding the merits, not reasons for denying the writ.

The petition argued that the writ should be granted because the majority opinion leaves the burgeoning loan note market completely outside the antifraud provisions and without any other investor protection. Petition at 11-13. Further, as the Commission argued forcefully in urging rehearing below, the majority opinion rips open an even larger "loophole in the coverage of the federal securities laws" by effectively holding "that so long as a note originally reflects a commercial loan by a commercial lender . . . its resale to others in 'discrete' portions cannot be a securities transaction." SEC Rehearing Statement at 2-3.

Security Pacific's retort that loan notes are not securities, thus rendering irrelevant the giant size of the market, misses the point. Br. in Opp. at 9-11. A petition for certiorari is not a referendum on the merits; it is about the significance and impact of the matters at issue. Sup. Ct. R. 10.1. There can be no dispute that a decision which, by distorting a decision of this Court, (i) exempts from the antifraud provisions a debt instrument that is sold as an alternative to and in the identical

---

2 As a practical matter, moreover, loan note purchasers—most of whom are non-lending and/or foreign institutions—plainly "[are] not in a position to approach the hundred or more possible borrowers in the program and conduct their own examinations." (12a).

3 *See, e.g., American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.*, 635 F.2d 1247, 1254 (7th Cir. 1980) (participant "conducted its own investigations of the project" and "retained the rights of a lender to demand foreclosure, preclude substitution or release of collateral, prevent modification of terms of loan obligation, and so on"), *cert. denied*, 451 U.S. 911 (1981); *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1178 (6th Cir.) (participating bank had access to all of the lending company's records concerning loan), *cert. denied*, 454 U.S. 1124 (1981).

manner as a recognized security, and of which more than $100 billion is sold annually, and (ii) invites similar exemptions for any number of other debt instruments, raises issues and concerns that require this Court's intervention and guidance.[4]

3. Finally, Security Pacific only *confirms* the need for this Court to remedy the panel majority's distortion of *Reves*. *Reves* emphasized that its test was designed to distinguish investments from commercial transactions. 494 U.S. at 63. Like the panel majority, Security Pacific ignores in its own *Reves* analysis the economic reality of loan notes and the motivations of the investors who purchase them.

a. Security Pacific argues that the "motivations of the parties to the transaction" is commercial because advances to Integrated—the issuer—were made "to facilitate [Integrated's] current operations" and not to "raise capital." Br. in Opp. at 12. Whatever the meaning of that "distinction", Security Pacific, like the panel majority, ignores completely that as primarily non-financial, non-lending institutions, loan note purchasers could have been motivated only by an *investment* purpose—precisely the motivation which Security Pacific's entire promotion and marketing program was geared to exploit.

b. Security Pacific argues that loan notes are not sold to "a broad segment of the public" because they were not

---

4 Security Pacific similarly cannot avoid the writ by asserting, on "policy" grounds, that petitioners improperly seek "to impose on the loan participation business a vast regime of securities law requirements wholly foreign to its origin or operation." Br. in Opp. at 6. In fact, if loan notes are deemed securities, Security Pacific would be constrained only from misrepresenting its product. That is precisely the requirement that has applied since 1933 to sellers of commercial paper—a market that now exceeds $500 billion. No other regulation need apply; as the Commission has explained, loan note sales easily can be structured to avoid any registration requirements "either because they may qualify for exemption under the short-term note provision in Section 3(a)(3) of the Act or because the offers and sales could be structured in such a fashion as to qualify as a private placement pursuant to Section 4(2)." SEC Brief at 44.

purchased here by individual investors. Br. in Opp. at 14-15. Like the panel majority, Security Pacific ignores completely (i) that virtually all short-term corporate debt has always been purchased by institutional investors,[5] (ii) that Congress knew commercial paper is sold almost exclusively to sophisticated institutions but directed anyway that commercial paper be deemed a security,[6] and (iii) that Security Pacific's sale of loan notes to nearly 1,000 investors between 1986 and 1990, and its conceded willingness to sell loan notes to any entity with the cash to invest, represents an offering to a broad segment of the relevant investing public.

c. Security Pacific argues that purchasers understood they were taking loan participations because of certain commercial lending terms used in the MPA. Br. in Opp. at 15-16.[7] Like the panel majority, Security Pacific ignores that fine-print language in a form agreement cannot outweigh, from an investor's perspective, the expectations generated by Security Pacific's intensive sales pitch that encouraged

---

5 *See* SEC Brief at 22 (and sources cited therein).

6 Security Pacific relies on a footnote from a recent magazine article for the proposition that private placements are exempt from the antifraud provisions, and argues that commercial paper itself is not a "real" security. Br. in Opp. at 11 & n.14. Section 12(2), 15 U.S.C. 77l, however, clearly allows *no* exemption from the antifraud provisions for securities distributed pursuant to private placements. Similarly, both this Court and the legislative history of the 1933 Act are explicit that commercial paper *is* a security, subject fully to the antifraud provisions in the Securities Act. *See Securities Indus. Assoc. v. Board of Governors*, 468 U.S. 137, 151 (1984) (summarizing legislative history).

7 Security Pacific asserts that "each and every document" provided to purchasers "emphasized" that loan participations were being offered for sale. Br. in Opp. at 15. As Security Pacific's appendix reference reveals, however, the form MPA is the *only* document making any such reference. Although not referred to by the courts below, Security Pacific also pretends that petitioners' genuine expectations should have been influenced by the state of the caselaw on loan participations, and by an unpublished speech that a bank sales representative made in 1988 at a meeting in Cleveland. *Id.* at 16.

"*investors*" to "*invest* in loan notes" because their yields compare favorably with those of their "commercial paper *equivalents*" (11a-12a; emphases added), and by Security Pacific's operation of its loan note program in a manner indistinguishable from a securities distribution.

d. Finally, Security Pacific argues that OCC Circular 181 renders unnecessary the antifraud provisions by "addressing the sale of loan participations." Br. in Opp. at 17. Security Pacific also goes beyond the panel majority, asserting without authority and squarely contrary to this Court's instruction in *Reves* (494 U.S. at 69), that the absence of alternative risk-reducing regulation is irrelevant unless an instrument is a "security" under each of the first three *Reves* tests. *Id.*

Like the panel majority, Security Pacific chooses to ignore that OCC Circular 181 imposes no requirements on banks selling loan participations or loan notes. And while Security Pacific asserts half-heartedly to the contrary, the OCC's own interpretative materials are explicit that the Circular imposes *no* requirements on sellers, and certainly offers purchasers nothing in the way of "significant" protection, as required under *Reves*. *See, e.g.*, Letter of William B. Glidden, Assistant Director, OCC Legal Advisory Services Division, December 18, 1985 at 2. (A 219-20).[8]

By ignoring the economic reality of loan notes, Security Pacific's "defense" of the majority opinion underscores the need for the writ to correct the distortion below of the methodology and reasoning of *Reves*. The Commission's blunt char-

8 Security Pacific cannot even contend that it complied here with the "requirements" of Circular 181. To the contrary, it purports to disclaim in the MPA any obligation to disclose non-public information. Br. in Opp. at 5. Thus, while the Circular requires that national banks *purchasing* loan participations review all credit information (49a)—including non-public information—petitioners received only limited public information about Integrated, not the substantial non-public information known to Security Pacific.

acterization of the majority opinion applies with even greater force to Security Pacific's analysis: it "endorses sweeping principles that could read out from coverage of the federal securities laws sales of debt to persons who plainly require the protection of those laws." SEC Rehearing Statement at 2.

CONCLUSION

For the above reasons, and those set forth in the petition, the writ of certiorari should be granted.

Dated: January 5, 1993

Respectfully submitted,

JACK P. LEVIN
Counsel of Record
LAWRENCE A. DARBY, III
GERARD E. LYNCH
J. JAY LOBELL
HOWARD, DARBY & LEVIN
1330 Avenue of the Americas
New York, New York 10019
(212) 841-1000

Counsel for Petitioners

Of Counsel:

EDWARD L. POWERS
RICHARDS & O'NEIL
885 Third Avenue
New York, New York 10022
(212) 207-1200